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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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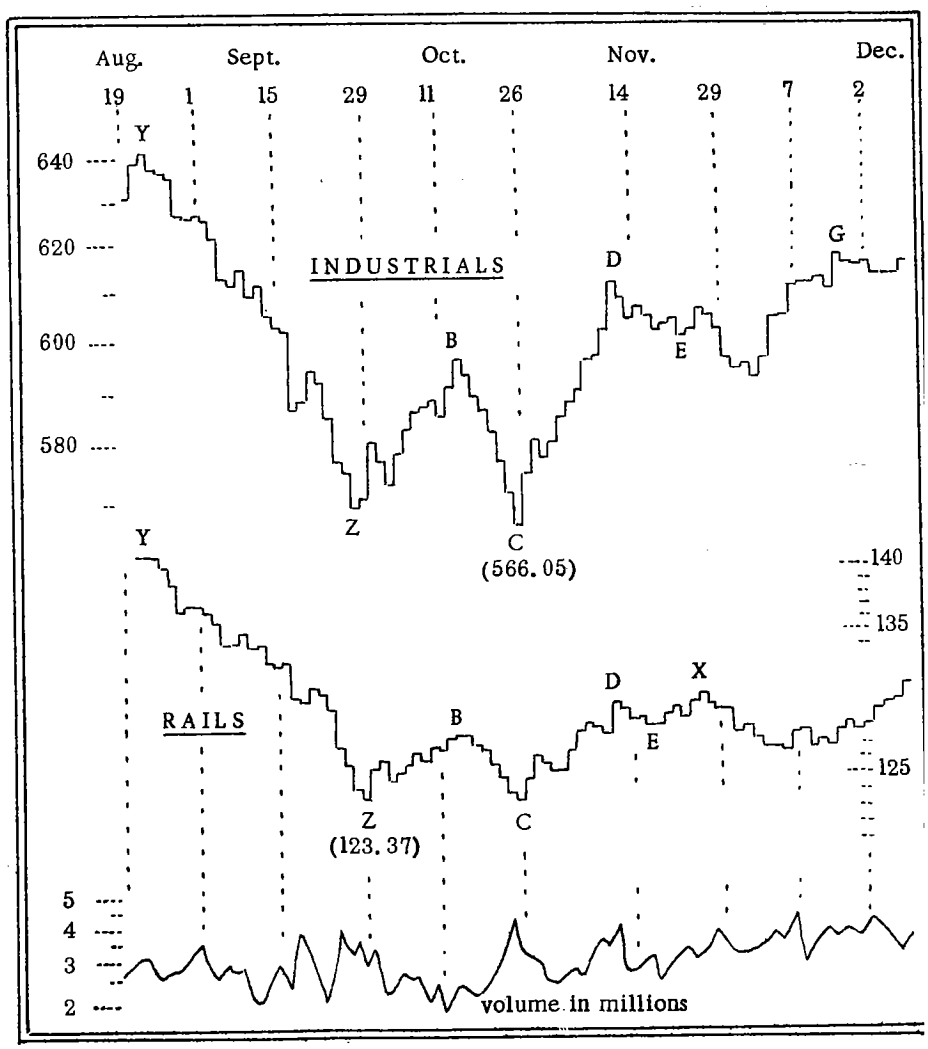
THE MARKET On November 10, 1960, the Industrial and Rail Averages touched the secondary peaks marked D on chart. Following this, a strange series of "see-sawing" movements occurred. Rails touched a new high at X (130.13), then declined as Industrials rallied to record a further peak at G (617.78). Finally, on December 28 Rails hurdled their preceding peak at X. Strangely, however, the Rail confirmation found Industrials advancing "in gear" but holding below their preceding high of 617.78.

The "rollercoaster" action of the Averages leaves this writer with a vague feeling of uneasiness. A friend of mine who is a surgeon told me that in the course of a routine operation he occasionally senses something (perhaps unconsciously) which bothers him, but which he cannot explain or "put his scalpel on". Occasionally, that "something" proves to be a matter of real importance; at other times it turns out to be a figment of his own cautiousness. "The longer you're in this business," he explains, "the more attuned you become to danger. Little things that you never would have noticed as an intern crop up to bother you after your thousandth operation."

I have no equity position to speak of at this time, and it makes little difference to me whether the next swing of the market is up or down. From the standpoint of a bull, however, it would bother me that the confirmation came in the last week of December (the Christmas to New Year rally is the surest of the year), and it would bother me that Industrials were not in new high ground (above G - 617.78) when Rails finally bettered 130.13 (X).

Trying to guage the quality of the buying and selling is the hardest thing in the world to do. It is of interest, however, that since the Industrial peak at D (612.01), 32 trading days have elapsed. Volume in that period has averaged 3.38 million shares per day, the highest volume since June. Yet as of this writing, Industrials have only advanced 4 points from their November 10 high. Obviously, a lot of stock has been offered for sale at the market price. Taken on a cold appraisal of the Averages, the suggestion would be that the market has been "churning".

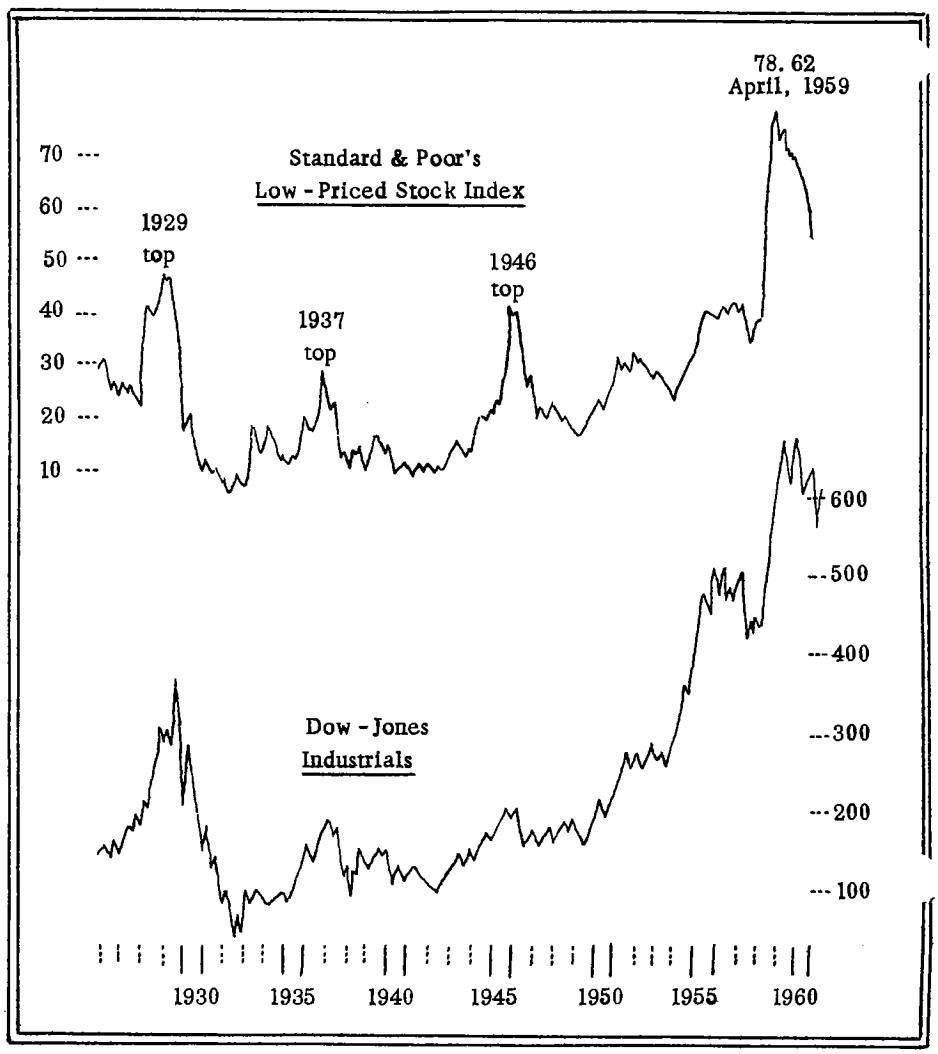


Many subscribers have written or called to tell me that they made speculative purchases when the two Averages bettered the B points (Letter 122). Others called on December 28 to tell me that they were chancing purchases on the strength of the Rail confirmation above 130.13 (X). A number of these correspondents are professionals or market veterans and they are "going in with both eyes open". Personally, and at the risk of being wrong, I am going to remain on the sidelines. I suggest that readers review the section entitled "Jumping the Gun" from Letter 127.

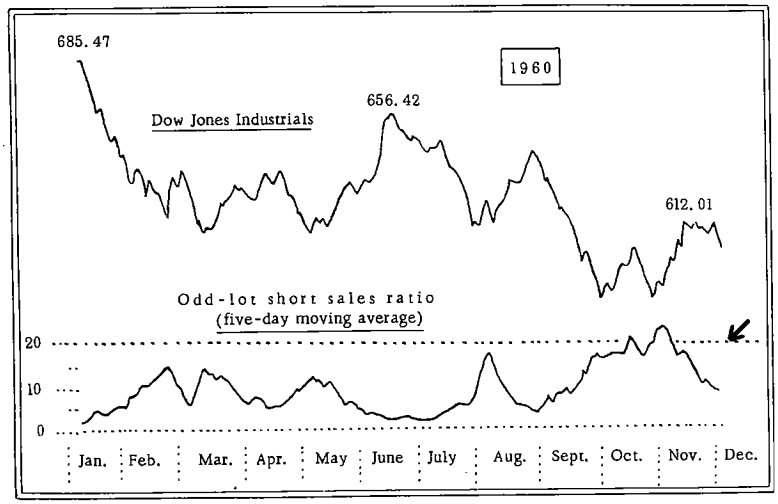
LOW-PRICED STOCK MOVEMENTS One of the least studied (and least understood) of all market phenomena is the price action of low-priced (L-P) stocks. Standard & Poor's L-P Stock Index is the oldest L-P stock average available. It was started in 1941 and has been plotted back (retrospectively) to 1926. Thus S & P provides the only long-term record of L-P stock action.

The accompanying chart shows S & P's L-P Index superimposed upon the high-grade D-J Industrial Average (1926 to the present). Note that there have been four great surges in L-P stocks over the last thirty-four years: the first came in 1928, the second in 1936-37, the third in 1945-46 and the most recent in 1958-59. On each violent L-P stock advance the peak in that Index was recorded well ahead of the final peak in the D-J Industrial Average (with the exception of 1937, at which time the Dow and the L-P Index both "topped" in March).

It is important to realize that following each great surge in L-P stocks, the L-P Index has turned down and fallen away without so much as a 15% rally. On the 1929 collapse, for instance, the D-J Industrials "crashed" from a price of 381 (September) to 198 (October). A tremendous recovery followed, which took Industrials back to 294 in April of 1930. But note the action of the L-P Stock Index during the same period. The Index "topped" in November, 1928, held steady through the first quarter of 1929, then caved in well ahead of the general market. The great secondary (upward) reaction which began in October, 1929, produced no more than a feeble upward ripple in the L-P Index, following which that Index turned down again with the market in April, 1930. In other words, history suggests that once the L-P Index records its final "spear-point" top, it collapses with little or no contra-trend rally.

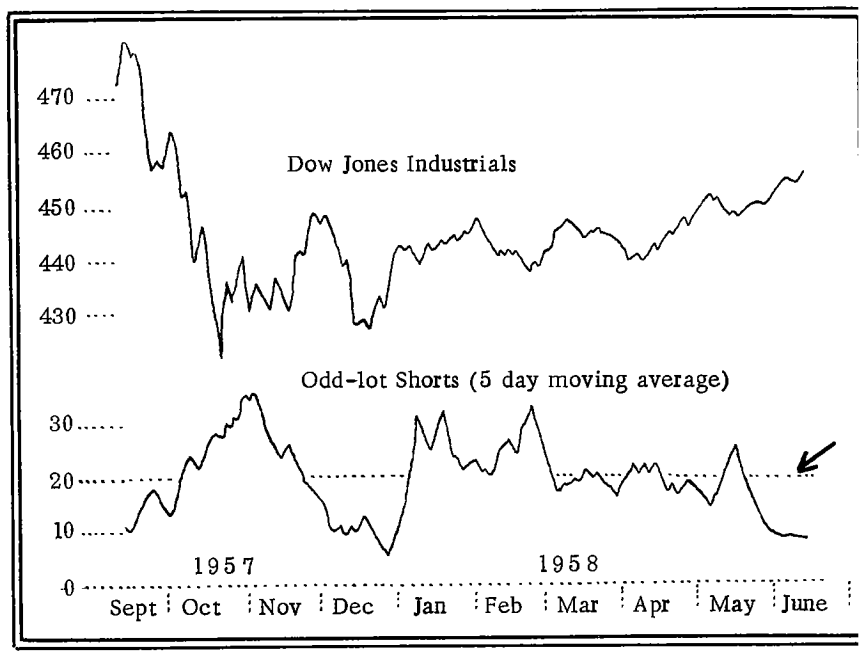


In view of this, the present picture is most interesting. S & P's Index touched an all-time high of 78.62 in April, 1959, nineteen months ago. Since then the path of the Index has been steadily and relentlessly down (a low of 54.05 was recorded in December, 1960). This suggests that the L-P stock group has made its move for the 1949-59 bull market. If the L-P Index now (1) rallies strongly, (2) forms a "double top" or (3) goes to a new high, we will have seen something new in market history.



ODD-LOT SHORTS Letter 126 contained a study of the current odd-lot short pattern. Because of that study and because of the December 19 Barron's article (entitled "Will History Repeat?"), I have received many requests for a comparison of the odd-lot shorts during the 1957-58 and 1960 periods.

The smaller chart brings the study from Letter 126 up to date. Note that the highest rate of odd-lot shorting in 1960 came towards the end of October, at which time the odd-lot short ratio climbed above 20 and held there for eight days. Since then, the rate of odd-lot shorting has dropped sharply. It should be understood, however, that odd-lot shorting always decreases during the last week or two of the year (perhaps the odd-lot public is normally optimistic about the coming year).



The larger chart shows the period of the 1957 reaction bottom, which included late 1957 and early 1958. Note that from October to November, 1957, the odd-lot short ratio held above 20 (actually rising above 30 for a few days). The normal end of the year drop in shorts came in December, but from January through May, 1958, the ratio again held above 20 with part of January and February climbing into the 30 area. In other words, from October, 1957, to early May, 1958, odd-lot shorting held in the 20 to 30 area, reflecting a great deal of bearishness over an extended period of time. This shorting is particularly significant when it is realized that between October, 1957, and April, 1958, the Industrials fluctuated within an area of only 38 points. Thus a solid six-month base was formed preparatory to the 1958-59 advance.

SUNDRY THOUGHTS Seldom have the technical indicators received such wide publicity in the nation's press. The "breadth of the market" (advance-decline ratio) has been good, the odd-lotters have been selling on balance (bullish), the Confidence Index is pointing to better things ahead, the short position is rising and the market has held in the face of gloomy business statistics. Wall Street, we are told, is patiently waiting for the new bull market to assert itself, while even Business Week Magazine (Dec. 24, 1960) makes bold to venture: "The chances are that the Dow Jones Industrial Index will exceed its old high of 680 in 1960, perhaps going to 700; and the more comprehensive Standard & Poor's 425 stock Industrial Average may go above its old high of 65 by, say 10%."

There seems to be little choice left for the informed investor; he must simply close his eyes and purchase a selection of "sound equities". By mid-1961 (allowing for a six-month capital gains waiting period), he will be able to distribute his acquisitions to an eager and avaricious "crowd". This observer does not deny the possibility that all this may come to pass; yet the procedure seems too well-advertised and too "pat" for comfort. "When in doubt," runs the old market adage, "do nothing". Barring some of the possibilities outlined in Letter 127, I must admit that I am plagued by doubts.

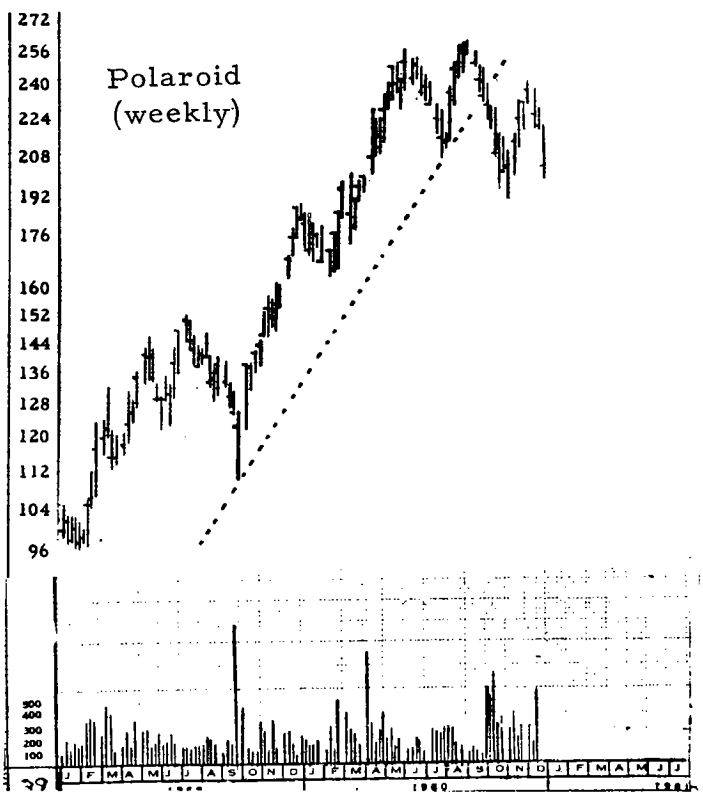
Regarding year-end predictions, Hamilton once remarked that "...the reviews are better than the forecasts." As of this writing there exists an almost unanimous opinion to the effect that the economy will dip slightly during the first and perhaps second quarters of 1961, following which business will turn up and enter a new and healthy phase of expansion. This happy prediction graces the pages of literally every financial magazine in the country. So widely held is the "first-half dip, second-half rise" thesis that Walter Heller (Chairman of Kennedy's Council of Economic Advisers) found himself apologizing as he joined what he sheepishly referred to as "the six-month club".

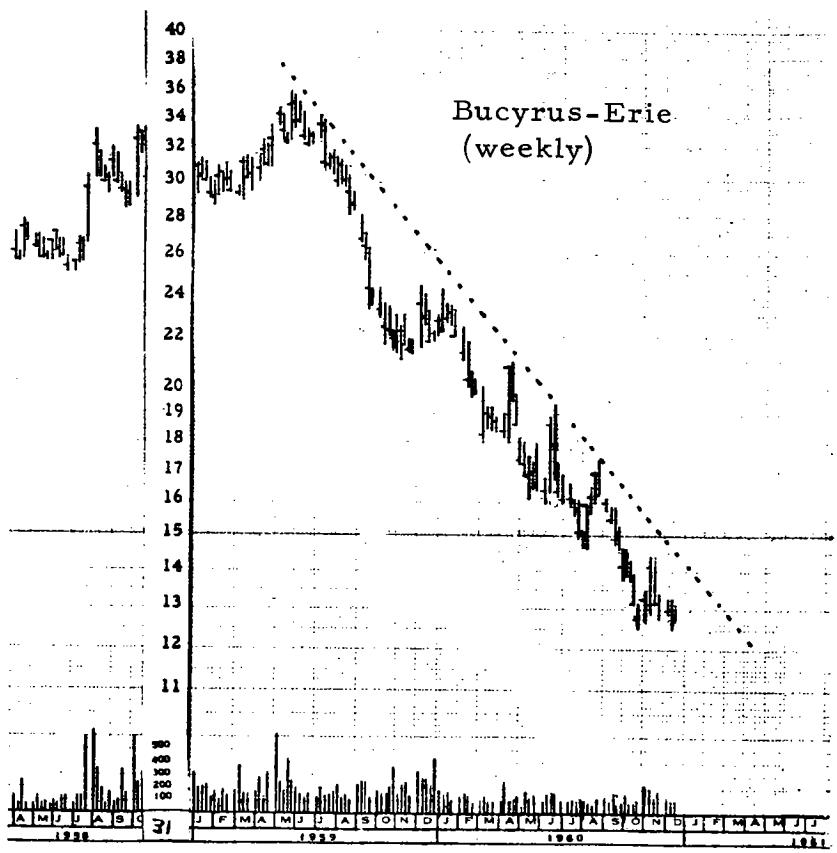
When everybody thinks the same, it is safe to say that nobody is thinking. At such times, "contrary opinions" often come surprisingly close to the facts. In the present situation either of the following contrary opinions might apply: (1) the economy will turn up sooner than anyone expects, following which (perhaps around mid-1961), a severe slump will start. (2) the economy will continue down with no pick-up at all during 1961. If either of these contrary possibilities were to materialize, it seems to me that the risk of buying equities would outweigh the possibility of reasonable gains.

STOCK OBSERVATIONS In Letter 110 (Polaroid was then 224) I called attention to the fact that PRD had broken a major trendline. Since then the stock has been in the process of forming a huge "head-and-shoulders" top, and it has dropped as low as 187. The "tip-off" on the recent weakness in PRD was the extreme drying up of volume on the July-August rally (the "head").

The second chart shows the complete collapse in BY. This is the sort of stock which is often used to excite the public on bear market rallies; it is a large and substantial company, it sold as high as 35 in mid-1959, it "looks cheap" in the 12 to 14 area and it is obviously due for some sort of an upward correction.

(Written Thursday, December 29th - 2 P.M.)





Charts courtesy of Traders Research
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